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Are fixed-income investments really out of favour?

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In late June, Britain's decision to leave the European Union triggered a brief but sharp sell-off in equities. Since then, markets globally have surpassed pre-Brexit levels, once again reminding investors of the perils of trying to time the market.

Fixed income has been getting a lot of attention recently. In Europe and Japan, positive yields have become hard to find. Investors in government bonds are now paying to lend instead of the opposite. The picture is slightly better in North America with the 10-year U.S. Treasury yielding 1.58% as of August 31, 2016. The same term issued by the Canadian government was yielding 1.02%. This has a significant effect on retirees who rely on interest income to cover their retirement costs, as their expected return will not cover the drawdown due to inflation.

What makes bonds interesting is that they are continuously re-priced based on future interest rate expectations. All else being equal, if interest rates rise, bond prices will fall and vice versa. So, what effect would an increase in yield of 100 basis points across a 10-year horizon have on the 10-year U.S. Treasury investment? It would trigger a capital loss of 9%. The only source of return from this investment would be interest income at a rate of 1.58% per year. Therefore, it would take approximately 5.7 years to "pay for" or recoup the 9% loss. Investors would have to hold the investment for almost six years to avoid a loss in exchange for 1.58% in interest income per year for 10 years. However, the value of this investment also has the potential to rise before its maturity at the end of the 10th year. If the yield fell 100 basis points to 0.58%, it would trigger a gain of 9%. This is not as impossible as it may seem, as countries such as France, Germany, Switzerland, the Netherlands, Sweden, and Japan are already trading at or below this level.

What is, in fact, impossible to predict is whether interest rates will rise or fall. In a "normal" economy, interest rates, inflation and GDP growth are usually higher than current levels, unemployment is lower and there is less central bank involvement. Many thought the lowest interest rate possible was zero, meaning lenders would not accept a negative interest rate to lend. However, Japan, Germany, the Netherlands and Switzerland have proved us wrong, with negative interest rates on even a 10-year term.

Nevertheless, government bonds remain an important income class because the government's ability to tax and print money makes it much more likely you will receive your capital back at the end of the term. They also tend to perform well when everything else (stocks, commodities) does not. We like to pair this investment with asset classes that exhibit negative correlation, meaning the paired asset class would have

strong returns when interest rates rise. The strongest contender is the U.S. dollar, followed by stocks of companies with low leverage and corporate bonds.

We construct portfolios that provide exposure to various economic environments and include government bonds, corporate bonds, stocks, the U.S. dollar and other currencies. We create combinations that we believe will have lower volatility and generate more predictable returns for our investors. Our final blend depends on investors' risk tolerance and holding period and the relative valuations and correlations of asset classes. We fine-tune the asset mixes as valuations and correlations change. By optimizing the asset mix of our portfolios, we can provide solutions intended for investors with less than a five-year investment period and an expectation to beat inflation.

Combined top 15 equity holdings as of August 31, 2016 of the Evolution 40i60e Standard portfolio with Alpha-style exposure:

1. Microsoft	6. Chubb	11. UnitedHealth
2. Altagas	7. Simon Property Group	12. CIBC
3. Atco	8. Toronto-Dominion Bank	13. Synchrony Financial
4. Alphabet – Class C	9. Manitoba Telecom Services	14. Walgreens Boots Alliance
5. Tourmaline Oil	10. Apple	15. Thermo Fisher Scientific